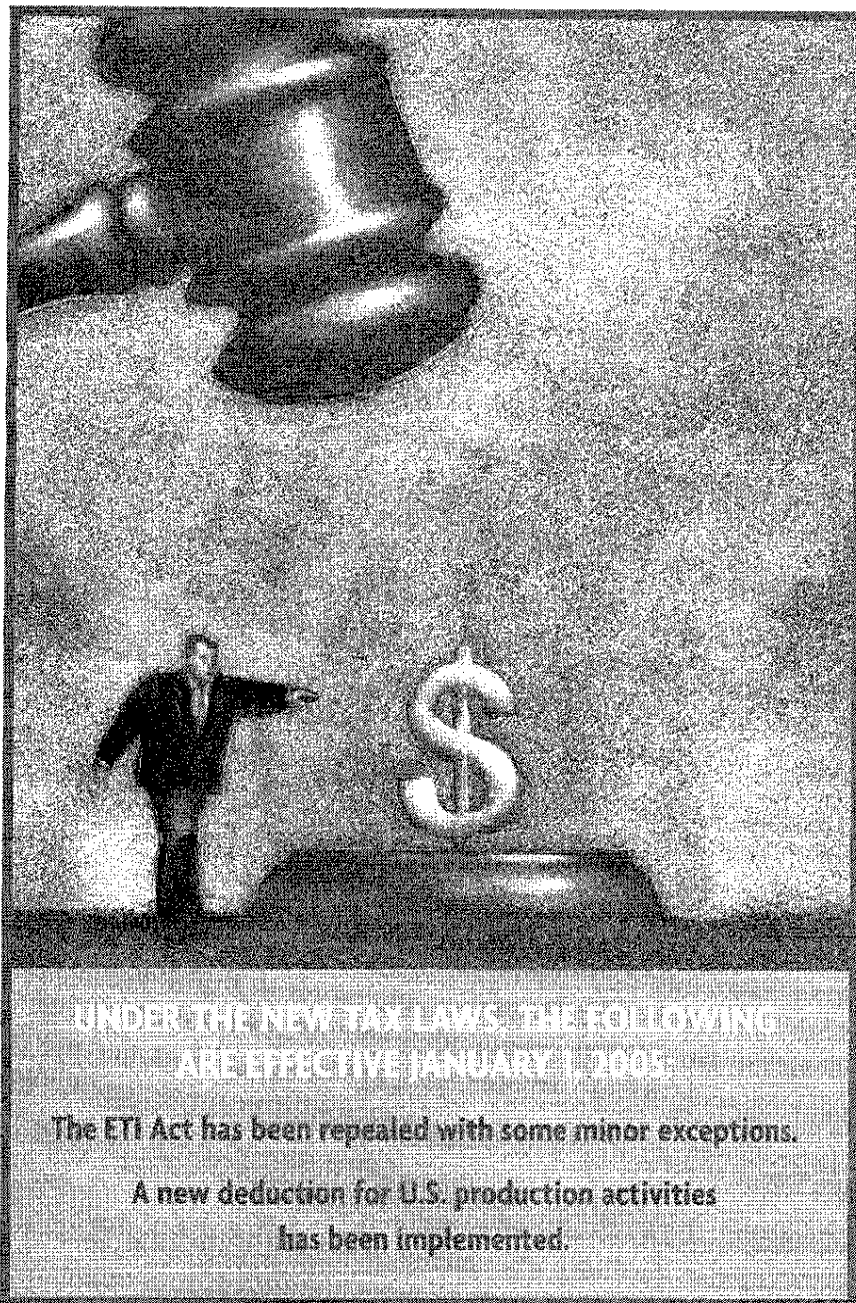


Easing the Squeeze

New Deductions Help Compensate for Increased Tariffs ▶ BY JEFFREY A. WARFIELD



Have you been feeling a tax squeeze when your products reach the border of a foreign country?

Many companies are being assessed increased tariffs on their exports, one of the reasons being the years of battling between the United States, European Union and the World Trade Organization over the United States' offer of export subsidies to domestic companies with overseas presence.

The W.T.O. and E.U., along with many other foreign countries, have claimed that certain parts of the federal tax codes provide an advantage to U.S. companies performing a business on foreign soil. The chronological history dates back to the early '70s when the U.S. tried to combat foreign trade competition by providing incentive tax breaks to domestic businesses that set up companies overseas to sell domestic products. There was opposition of these tax breaks from the European community, which perceived it as an illegal act against trade treaties.

In the late '90s the European Union requested that the W.T.O. make a determination as to whether the use of Foreign Sales Corporations by U.S. companies to export and sell domestic goods or perform services abroad was non-compliant with W.T.O. rules. After an unfavorable determination by the W.T.O. in 2000, the FSC's tax laws were repealed, thus abolishing the use of Foreign Sales Corporations.

The Extraterritorial Income Exclusion Act was then signed into action.

The ETI Act allows domestic companies to exclude a certain percentage of foreign income in determining their company's federal tax liability. Unlike the FSC, which applied primarily to overseas-based companies, this act provided benefits to U.S.-based exporters, including small businesses and proprietorships.

The W.T.O. again determined that this federal tax act was an illegal export subsidy. The kicker is that the W.T.O. has allowed the E.U. to sanction U.S. companies with tariffs on particular products. The tariffs started at 5 percent and were to max out at 17 percent of products exported, which is why you may feel a little more of a tax squeeze from other countries in the short term.

MAKING CHANGES

Congress has tried to ease these tariffs by repealing the ETI tax benefits. The primary purpose of the business tax act signed by President Bush back in October 2004 was to thwart the possibility of a trade war between the U.S. and the E.U. Even though there are many international and domestic law changes in the new act, a few are worth noting for the upcoming year.

Under the new tax laws, the following are effective Jan. 1, 2005:

The ETI Act has been repealed with some minor exceptions.

A new deduction for U.S. production activities has been implemented.

ETI REPEAL

For federal tax purposes, the exclusion from taxable income of certain qualified foreign trade income related to transactions overseas has been repealed. Qualified foreign trade income is based upon a percentage of income earned overseas from the services or sale, rental or lease of American-made products (primarily manu-

factured with U.S. materials).

In order to soften the blow for companies that have benefited from ETI in the past, the income exclusion will be phased out over the next couple of years and be completely eliminated by 2007.

U.S. PRODUCTION ACTIVITIES DEDUCTION

To compensate for the ETI repeal and follow W.T.O. guidelines, Congress implemented a tax deduction to stimulate domestic production activities. Even though it may sound like it applies solely to manufacturing companies that is not the case. This deduction may be applicable to construction, engineering and architectural services performed on American soil. This deduction may also apply to software, tangible property, electricity, gas and food produced within the U.S.

Unlike ETI, you are not required to export these products in order to obtain this deduction, as the primary focus is on the domestic production of the product or service.

The deduction is a percentage of certain production activities income net of expenses. The deduction will increase annually but is limited to a percentage of the company's paid salaries for each year. Please be aware that sole proprietors and limited liability companies with no employees may not benefit from this deduction because there are no "wages" being paid.

DOUBLE DIPPING

Since the ETI exclusion is being phased out over the next two years, some companies that produce products in the U.S. and then sell them overseas may benefit from both deductions.

GETTING YOUR MONEY BACK

For a limited period of time, those domestic businesses with accumulated

cash in subsidiary companies overseas can bring the cash back in to the U.S. in a form of a dividend with minimal tax consequences. This is a great benefit for those businesses that have left their foreign earnings in more tax friendly countries but were afraid that the U.S. government would take a sizeable chunk once the money hit home. The catch is that the cash has to be used in the activities of your domestic company (i.e., for production line activities, pay down debt, hiring employees, etc.). In order for the dividends to avoid significant tax implications, a dividend reinvestment plan has to be in place outlining the particular use of the money in the business. The cash has to be used as outlined in your plan and you should keep records of the cash outlays in case you get a friendly visit from the IRS. As with any tax issue, there are many potholes and pitfalls, so careful consideration and consultation with a tax advisor is recommended before proceeding.

MOVING FORWARD

These new provisions may ease some of the tax burden imposed on domestic companies with overseas presence or sales. Due to some of the nuances related to the ETI repeal, the E.U. is cautiously reviewing the law changes in order to determine if they are in compliance with W.T.O. guidelines before lifting any of the current tariffs imposed. It may be some time before there is relief from foreign tariffs.



Jeffrey A. Warfield, CPA, is a manager at Alexander, Aronson, Finning Co., PC. He joined the firm after working in public accounting for six years in Boston. He assists businesses looking to expand their operations internationally through the Alexander, Aronson, Finning's affiliated international accounting practices and provides advice regarding various international tax issues.